Ontario Studies in Tax Reform 3

Ontario Tax Studies

Technical Study on Tax Reform and Small Business

Staff Paper

Ontario

Department of Treasury and Economics
Taxation and Fiscal Policy Branch

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ONTARIO

Taxation and Fiscal Policy Branch
Ontario Department of Treasury and Economics

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PREFACE

Since the publication of its general *Ontario Proposals for Tax Reform in Canada,* the Ontario Government has developed further its proposals for small business taxation. These proposals are contained in the paper, *Tax Reform and Small Business,* presented by the Hon. C.S. MacNaughton, Treasurer of Ontario and Minister of Economics, to the federal-provincial meeting of Ministers of Finance in December 1970. This supporting study outlines in detail the technical features of the small business tax incentive proposed in the December paper.

Part I of this study elaborates upon the main features of the owner-operator incentive and suggests a number of qualifying tests, accounting procedures and operational rules to facilitate application and administration of the proposed incentive in the great majority of cases. Part II provides supporting material in the form of mathematical examples, comparisons and illustrations.

This staff study was undertaken in the Taxation and Fiscal Policy Branch, Ontario Department of Treasury and Economics, as part of the continuing series of Ontario Studies in Tax Reform. In preparing this study we drew on the expertise and knowledge of a number of outside advisers and consultants, including tax lawyers and accountants. We wish to acknowledge their major contribution.

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December, 1970

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PART I

OPERATIONAL DETAILS OF ONTARIO'S PROPOSED SMALL BUSINESS INCENTIVE

OPERATIONAL DETAILS OF ONTARIO'S PROPOSED SMALL BUSINESS INCENTIVE

Introduction

1 This paper outlines in detail the operational features of the proposed small business incentive advanced by the Ontario Government in its *Tax Reform and Small Business.*[1] A number of rules and procedures are suggested and after examination it may be necessary to develop some additional restrictions. It is expected, however, that confining the benefits of the incentive to Canadian resident individual owner-operators, limiting the benefit to 50 per cent of qualified investment or 50 per cent of tax otherwise payable, providing an annual limit on credits of $10,000 and a lifetime limit of $100,000, and providing for a potential recapture of credits should avoid the necessity for many further restrictions in the vast majority of cases. Complex cases may require more complex rules.

Canadian Individual Owner-Operator

2 The incentive is directed at the Canadian individual who owns and operates his own business. In the large majority of cases there should be no difficulty in identifying a Canadian resident individual as an owner-operator of a business. He will be the proprietor of a retail establishment or small manufacturing concern, one of the partners in a professional practice or the owner of the shares of a corporation through which he carries on his retailing, manufacturing or construction business.

3 In general, an owner-operator is the Canadian individual who finances and operates his own business. He will provide the equity capital of the business and will spend full or virtually full time working in the business.

4 At the same time, it is not intended to deny the incentive where capital is employed in a new business which may not require the full-time employment of the owner provided that he does make a significant working contribution to the business. In this way the development of a new business with the capital and part-time efforts of the owner would not be discouraged.

5 Non-residents, passive investors and employees with small shareholdings in their employer corporation would not be eligible for the incentive.

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[1] Hon. C. S. MacNaughton, *Tax Reform and Small Business,* Ontario Proposals for Tax Reform in Canada II, (Toronto: Department of Treasury and Economics, December, 1970). See also, Hon. C. S. MacNaughton, *Ontario Proposals for Tax Reform in Canada,* (Toronto: Department of Treasury and Economics, June, 1970), Chapter 6; hereinafter cited as the *Ontario Proposals.*

6 Owner-operators would thus include:

- all Canadian proprietors carrying on an active business in proprietorship form;
- any Canadian partner in a partnership carrying on an active business provided that the partner participated in the profits and losses of the business (i.e. was not restricted to a fixed annual or other periodic payment or to interest on his investment in the partnership) and who made a significant working contribution to the business of the partnership;
- any Canadian shareholder who owned not less than 25 per cent of the equity capital of a corporation carrying on an active business and who provided a significant working contribution to the business of the corporation, provided he was a member of a group of such shareholders which owned more than 50 per cent of the equity capital of the corporation; and,
- any Canadian member of an employee-shareholder group which owned more than 50 per cent of the equity capital of a corporation carrying on an active business, and each of whom were employed virtually full-time in the business of the corporation.

7 The incentive would be restricted to Canadian individuals and this should be a test determined by reference to tax status. Residents would qualify while non-residents, even though they might carry on business in Canada, should not. The business should be of an active nature and passive investment should not qualify.

8 The test of "significant working contribution" is intended to relate to the question of time devoted to the job, in the context of the size of the business and the amount of time which might reasonably be required, and to the question of whether that effort made a significant contribution to the business. Five hours a week could constitute a significant working contribution to a small proprietorship business carried on by a Canadian individual during what was otherwise time off from his regular employment. Five hours a week of employment in a large corporation by one of its shareholders generally would not constitute a significant working contribution.

9 The essence of qualifying should be determined on the facts and not according to technical rules. The final resort should be to the courts. Nonetheless, as the concrete situation can vary so much from one business arrangement to another, this could be a fruitful area for adopting an approach used in the United States. There, by so-called "proposed regulations", practical examples of different situations are given to illustrate the view of the tax authorities as to which side of the line a particular case will fall. Discussion is then invited, and "final regulations" promulgated. In terms of Canadian practice, this could be adapted to the new "Interpretation Bulletins" now being put out by the Taxation Division of the Department of National Revenue, except a draft bulletin could be put out

first for comment. While even the final interpretation bulletin would be subject to court appeal by taxpayers, it would provide the administrative basis for solving all but the most difficult cases.

10 All adult Canadians should qualify and, despite some risk of administrative difficulty in marginal cases, there is no reason why both a husband and wife could not qualify provided that all other tests, including that of a significant working contribution were met. In fact, this is more in keeping with the current social feeling that the relationship of marriage should not hold either party back. The age of nineteen might be an acceptable age for qualifying as an adult for the purposes of the incentive.

11 Taxpayers might indicate their intention to claim a small business incentive credit[2] and their belief that they qualify as an owner-operator by completing a prescribed form to be attached to the T1 return. This form would provide for the calculation of the credit and details of carryovers, etc., and would require some details of the business or businesses in respect of which the credit was being claimed.

Amount and Limits of SBI Credits

12 It is proposed that an owner-operator be entitled to a credit against his personal income tax of an amount equal to 50 per cent of his increased investment in his business within the other general limitations described. These were:

- the maximum annual SBI credit would be $10,000 and thus would provide a maximum annual incentive comparable to the maximum advantage generally afforded by the lower corporate rate of tax;

- there would be a lifetime limit of $100,000 of SBI credits, which would require $200,000 of increased business investment; and

- the maximum annual credit would be 50 per cent of tax otherwise payable before deducting any SBI credit; thus the taxpayer would have to pay an amount of income tax equal to or greater than his SBI credit.

13 By using a tax credit approach, the total amount of credit available to individuals would be unaffected by the level of their personal income. However, the timing of the deduction would be affected by a requirement that there be a maximum credit in any one year of 50 per cent of the personal income tax otherwise payable in that year. Only personal income tax would qualify for reduction. Capital gains under the *Ontario Proposals* would be taxed under a separate plan without reference to personal income taxation.

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[2] Hereinafter referred to as SBI credit.

14 No limits are proposed concerning either size or newness of the business. Having regard to the variety and breadth of the reasons of the Ontario Government for supporting special taxing arrangements for small businesses, it would seem clear that it is not a certain type of business but a certain type of businessman – the owner-operator who is to be encouraged.

15 If this is so, it would seem important not to penalize success, so that any supplementary test related to size of business would be inappropriate. Similarly, any effort to select in advance the type or newness of business in respect of which the owner-operator must qualify would unnecessarily narrow the field, having regard to the broad objectives which any small business incentives should promote. There would seem no reason in principle to disqualify a taxpayer for any reason other than that he was not or had ceased to be an owner-operator resident in Canada.

16 In summary, the concept of the Canadian owner-operator seems sounder in principle than the size or type of business as the basic test. The question remains whether an administratively workable definition of the "owner-operator" can be developed. The point of the distinction is to exclude passive and entrepreneurial investors from the basic small business incentive, and leave the appropriate treatment of these taxpayers to other taxing arrangements.

Increased Business Investment

17 The position of the Ontario Government is that any small business incentive should promote economic growth and efficiency through tax credits related to increased business investment in qualified assets. Thus, if there is no such increased investment there would be no tax relief even though the Canadian owner-operator qualified as such.

18 In the case of a proprietor, qualified investment would be the net investment in the business assets of the proprietorship at any time, comprising the initial and any subsequent investments and any net increase arising from retained profits from operations. In the case of a partner, it would be his share of such net investment including retained business profits invested in the business assets of the partnership. Finally, in the case of a corporation, it would be the aggregate of the shareholder-operator common or preferred share investment and any indebtedness of the corporation to him. The retention of earnings by the corporation would not in itself be treated as increased investment of the shareholder.

19 It would seem appropriate to include as a qualified investment borrowed money of a corporation guaranteed by the owner. There is no reason to be concerned with the source of investment, so long as the owner-operator either provides or guarantees the provision of the funds by a lender. If a guarantee did not qualify, a personal borrowing and lending to the company would have the same effect. Also, great difficulties would arise in establishing the

source of funds. All that should matter is the business investment and personal liability or risk. In fact, the existence of the incentive could make borrowing somewhat easier than otherwise.

20 Investment in certain assets and types of business should not qualify. For example, mineral investments (that is, investments qualifying for fast write-off and depletion) would be excluded as already covered by special industry rules. In the case of a property investment company, the appropriate level of capital cost allowance is the proper question to be decided, and an investment credit is a more appropriate approach if something more is needed. Again, portfolio-type investments in bonds, mortgages and shares should not qualify as being appropriately the subject of general rules relating to the taxation of income and gains from such investments. Other exclusions might be considered but, in general, it would seem that bona fide arm's length investment in every other kind of business asset should be permitted as most consistent with the purposes of the incentive. This would include intangible as well as tangible assets, there being no reason to exclude the former where its value is established in an arm's length transaction.

21 If one-half of the amount of increased qualified investment exceeded the amount of tax credits which could be taken in a particular year, the unused portion could be carried back one year and carried forward indefinitely. It could be taken as quickly as possible except for the limit of not more than 50 per cent reduction in tax in any one year. The taxpayer would also have to qualify as an owner-operator in each year in which a credit was claimed, although not necessarily with respect to the same business. In this way, timing of investments could be made in response to business and not tax considerations.

22 An incentive related only to earnings does nothing for the business which, one might argue, needs it most – the business suffering losses or not yet profitable. On the one hand, it is success related, which is desirable. On the other, it may jeopardize success, by not becoming available early enough in the life of a business. The investment-related approach at the individual level opens up two possibilities. First, if there is other personal income, the increased investment can be utilized and so reduce tax on that income even before the business earns income. Second, even if there is insufficient other personal income, a carry-forward provision could mean getting tax deductions as soon as income did develop. In this way, some of the disadvantages of an incentive determined by reference to earnings can be reduced for the struggling company. However, where there is insufficient income from any source over a long period, the only method of assistance is subsidy, with all the disadvantages necessarily involved, including the absence of the success test.

23 A lower tax rate unrelated to investment is unquestionably an incentive to all small business. Even under the Commons integration proposal there would be benefits of the low rate to entrepreneurial capital and passive investment, which could indirectly help the Canadian owner-operator. An open-ended forever incentive without any investment criteria

would inevitably mean stringent and complicated controls like the present associated corporation provisions and other restrictions such as size. It would also mean that some individuals would get more cumulative benefit than others, through investment in a number of qualifying corporations which nonetheless met the size and associated corporation tests. Finally, for the same revenue cost, an incentive which goes only to Canadian owner-operators and in respect of investment in business assets can be both effective and less restricted.

Accounting for Increased Investment and SBI Credits

24 It is expected that the initial test of increased qualified investment could be made by the owner-operator merely by comparing the amount of his investment in his business at the beginning and end of the year. Where an individual owner-operator formed a corporation to carry on a business during a year and invested $10,000 in the common shares of that company, he would have an increased investment in the business of $10,000 which generally would qualify as increased investment for SBI credit.

25 For capital gains tax purposes, it would be necessary, in the normal course, that a taxpayer maintain a record of the "adjusted cost basis" of his investment for purposes of computing a subsequent capital gain or loss. An investment of $10,000 in the common shares of a company would initially give a cost basis of $10,000 and a sale of those shares for some other amount would give rise to a capital gain or loss. It is proposed that a decision to claim an SBI credit give rise to an adjustment to the cost basis of the shares to the extent that the increased investment has given rise to an SBI credit. Should the full $10,000 of increased investment give rise to SBI credit, the taxpayer would reduce the cost basis of his investment by $10,000 to zero.

26 Generally, any increase in the amount of investment in a corporation should qualify for SBI credit within the general limitations prescribed. This should be determined by reference to the tax values of the owner-operator's interest in the business and thus rollovers or tax-free exchanges should not have any effect. Some adjustments to the cost basis of the investment, such as capitalized carrying charges, should not qualify as increased investment.

27 It should not be necessary that the funds be invested directly in the business by the owner-operator but an investment made to acquire an existing business should be eligible subject to the general rules and restrictions. Again, the cost basis of the owner-operator's investment should be the main determinant and not the amounts of capital reflected on the corporate balance sheet. It might be possible to permit qualified investment through a chain of corporations but detailed rules would need to be prescribed. It would seem preferable to restrict the SBI credit, at least initially, to direct investment of the owner-operator.

28 In some cases the owner-operator would not be able to utilize his full increased investment for SBI credit and the unused investment could be carried forward indefinitely (and back one year) to provide SBI credits in another year. The cost basis of the investment would be increased by the amount of increased investment made in the year and reduced by the portion of that investment utilized in claiming SBI credit in the year.

29 Where the owner-operator had unused increased investment which was carried forward from a prior year, he would treat the carry-forward as an additional investment of the current year. The SBI credit would only be available if the taxpayer qualified as an owner-operator during the year. Thus, any carry-forward would be ineffective if in the subsequent year the taxpayer had ceased to qualify as an owner-operator, but the amount would continue to be eligible for carry-forward should he subsequently reacquire owner-operator status.

30 The claiming of SBI credit would be optional to the taxpayer and he could assign all or part of it to any or all of his investment in the business as he saw fit. Thus, if a shareholder-operator wished to increase his capital stock investment and, in addition, to advance funds to the company by way of loan, he could assign the SBI credit to his capital stock investment or to his loan account in any proportion which he wished.

31 With this suggested flexibility to the owner-operator in dealing with his investment it would be necessary to provide some rules to prevent SBI credit being claimed in respect of investment made late in the year and withdrawn early in the next. It would seem that rules similar to those now used in dealing with corporate loans to shareholders (i.e. a one-year minimum investment test together with restrictions against a series of investments and withdrawals) could be used to preclude this type of investment from qualifying.

32 One criticism of the present low rate of corporate tax is that it is available whether or not the funds are reinvested in the business. It is possible to withdraw the corporate profits in a number of ways without disturbing the entitlement to the low rate. By restricting the SBI credit by reference to funds invested in the business, the credit is automatically denied if funds are not invested and is recaptured if they are subsequently withdrawn. Thus, in those cases where funds are not to be invested, the owner-operator generally would be free to draw business earnings for personal consumption and his tax would be of the same magnitude as any other Canadian individual with a similar amount of earned income.

33 It is expected that much the same procedures could be adopted for owner-operators of both unincorporated and incorporated businesses. However, some more detailed rules would need to be developed for unincorporated businesses since it is unusual for proprietors and partners to buy, sell, or otherwise deal with business interests. Rather, they tend to deal with specific assets. In general, it is believed that the owner-operator of a proprietorship or partnership should be permitted the SBI credit in the same way as the owner-operator choosing the corporate form to carry on his business.

34 In the case of a proprietorship or partnership the determinant balance sheet for computing the amount of increased investment should be that drawn on the basis of tax accounting. It should include only those assets and liabilities recognized for tax purposes with tax values ascribed to them. Frequently, this would be the only balance sheet prepared for the business.

Recovery of SBI Credits

35 Basically, the present and the proposed Commons and Senate incentives are permanent. The advantage received need never be repaid. However, the Commons report would impose a higher tax on distributions of earnings retained through operation of the incentive. Neither report proposes different tax treatment of capital gains dependent upon whether or not the corporation benefited from an incentive – although obviously the amount of capital gains subject to tax would normally be greater due to increased retained earnings. In that sense, there may be said to be a recovery at the shareholder level of tax reductions at the corporate level.

36 It is proposed that the SBI credit be subject to recapture if the owner-operator realized a gain on his investment through sale, or otherwise, or if there is a deemed realization on gift, death or permanent emigration. Gains would be measured by reference to the adjusted cost basis of the investment. Since the SBI credit would be allowed at a rate of 50 per cent any recapture should generally be taxable at a 50 per cent rate.

37 In addition to sale of an investment, tax credit recoveries would arise on a reduction in qualified business assets, where the reduction occurred from dividends, capital or loan repayments or other corporate distributions, or through investing in non-qualified assets. However, this would not apply to capital or operating losses, rollover situations or distributions of fully integrated earnings. Otherwise, in loss situations, the tax recovery would arise when it was least able to be paid, and the risk of recovery at such a time would inhibit risk-taking by increasing the price of failure. Ceasing to qualify as an owner-operator would not in itself give rise to a recapture of SBI credits if there had been no taxable realization.

38 The taxpayer would keep track of any SBI credits claimed in much the same way as he must do when accounting for depreciable property and recaptured capital cost allowances. In the same way as recaptured capital cost allowances are taxed as ordinary income and any proceeds in excess of original cost are treated as a capital gain, any realization in excess of the adjusted cost basis of the investment would be considered a recovery of any SBI credits claimed (taxable at a 50 per cent rate), and any additional gain would be taxed as a capital gain. Any tax paid on recaptured SBI credits should not be included in determining the amount of tax otherwise payable for purposes of determining additional SBI credits.

39 A potential recapture of SBI credits could be offset by increased qualified investment in the year, including any amount carried forward from a prior year. Any owner-operator having claimed the lifetime maximum of \$100,000 of SBI credits would thus continue to keep a record of further increased investment which, while not qualifying for additional SBI credits, would be available to offset amounts otherwise subject to recapture.

40 In determining the lifetime amount of SBI credits (for the \$100,000 lifetime limit) any amounts claimed would be reduced by amounts recaptured. Thus, amounts recaptured would effectively restore a portion of the right to additional credits during lifetime. To the extent that the taxpayer suffered a loss on an investment on which SBI credits had been claimed, any net capital loss would be deductible, there would be no recapture of SBI credits and those previously claimed would continue to be included in determining the lifetime maximum.

Transfers between Qualified Investments

41 Where proceeds of a sale or withdrawal were reinvested within a specified time in the same or another business, a deferral of recovery could be permitted until there was a permanent disinvestment. Quite clearly, the broader the rollover, the less adverse the effects of the recovery feature. For example, with a proper rollover, there would be no interference with a sensible sale of one business and the starting up or acquiring of another.

42 It is proposed that the investment by the owner-operator be eligible for SBI credit whether invested by way of share capital or debt. Similar accounting would be followed for each and a transfer from one to the other within the same business or between two qualifying businesses should not give rise to recapture of SBI credits nor affect the current year's entitlement to further credits.

Cash and Stock Dividends

43 Cash dividends from a qualified corporation would, in the normal course, be considered a realization for SBI credit purposes except to the extent that they represented a distribution of earnings eligible for full integration (to the extent such is provided for under the new system). As a realization, the dividend would be taxed at a 50 per cent rate to achieve recovery of SBI credits claimed. To the extent that a cash dividend from non-integrated earnings exceeded the amount of SBI credits previously claimed, it would be taxed at personal rates with dividend tax credit.

44 In the case of a stock dividend eligible for rollover or other non-income recognition, there would be no increased investment and no adjustment to the cost basis of the shareholder's investment. If the stock dividend gave rise to a potential recovery of SBI credits or was taxed as an ordinary dividend, the new stock investment would qualify as

increased investment for the year. Any subsequent redemption of the stock would constitute a realization.

Non-qualified Investment

45 It is intended that the SBI credit act as an incentive to increased investment in Canadian business. Thus, investment in non-qualified business assets, such as securities and property investment, should disqualify an equal amount of increased investment or be treated as a realization by the shareholder on his investment to the extent of his accumulated SBI credits. Non-qualified investment would not totally disqualify the owner-operator from SBI credits but would effectively provide a threshold which he would have to exceed before increased investment would qualify. For this purpose, the tax cost of the investment would be used – not its market value.

46 An investment in a wholly-owned subsidiary company should not constitute a non-qualified investment provided all tests of owner-operator, etc. could be met with regard to that subsidiary company. In such case the parent and subsidiary should be considered on a consolidated basis.

47 In order to avoid interfering with normal business activity, the investment of temporary surplus funds should not constitute a non-qualified investment provided the funds were invested in bank deposits or short-term debt obligations. Safe-haven rules might be developed. For example. the investment of funds in other than normal business assets for a period in excess of one year could create a presumption of non-qualified investment.

48 Where an acquired business had non-qualified investments at the time of acquisition, the amount of investment of the owner-operator should be reduced by the value of his proportionate interest in the non-qualified investment at the time he acquired the business. To the extent that a business had accumulated non-qualified investment when owned by an owner-operator, but prior to his claiming SBI credit, the cost of non-qualified investment should be deducted from the cost of his investment (including any current increase) when determining his increased investment for the year.

49 Where non-qualified investment had previously been treated as a realization or had reduced the amount of eligible investment, the conversion of that investment into qualified business assets should be treated as an increased investment of the year.

Taxation of Recovered SBI Credits at Capital Gains Rates

50 As a further incentive to retention of investment, it could be provided that any recapture of SBI credits be eligible for capital gains treatment after some suitable length of time, say five years. Similarly, any estate having a gross value of less than a specified amount, say $100,000, could have any recaptured SBI credits taxed as capital gains rather than at the 50 per cent rate. As capital gains, these amounts would be taxed at a 25 per cent rate.

51 In order to reduce any lock-in effect, any recapture of SBI credits otherwise taxable as a capital gain (i.e. the five-year or small estate situation) should be capable of deferral by way of one non-taxable rollover into a new investment of any type. Thereafter, the general rules for taxing capital gains would apply.

Small Investment Restriction

52 For administrative convenience, it would seem preferable to provide some small investment restrictions to avoid dealing with small SBI credit claims and, on the other side, with small amounts of recapture. Thus, it is proposed that increased investments or realizations of less that $100 be ineligible for current credit nor liable to current tax. Rather, such amounts would carry-forward and be aggregated with further increases or decreases until the $100 limit had been passed.

Transactions not at Arm's Length

53 It is hoped that severe restrictions would not have to be placed on transactions not at arm's length. It may be necessary initially to exclude acquisitions not at arm's length from qualifying as increased investment, at least until the capital gains tax has been in place for a period of time and some experience is gained with the proposed incentive. Thereafter, the only general rule in a situation not at arm's length would be that an acquisition for a debt obligation of the purchaser would not be treated as new investment until the debt was wholly or partly retired. A gift or bequest would be treated as a realization (the rollover concept would be inapplicable because there would be no proceeds to reinvest) and a new investment of the donee.

Loss Years

54 In the case of a corporation there may need to be some restrictions on owner-operator salaries where those salaries would push the company into a loss position or add to an otherwise existing loss. Without such a restriction, credits may be claimed at a 50 per cent rate and effectively taxed at lower rates. The general rules restricting the incentive to owner-operators, limiting the credit to half the amount of tax otherwise payable, and the

fact that salaries would be taxed on the personal rate schedule would provide an element of protection against significant amounts being involved.

55 Somewhat similar procedures would be required in dealing with proprietor or partner drawings which exceeded profits for the year. Generally, such excess drawings would constitute a realization on the investment, but some provision would need to be made to permit the withdrawal of some reasonable amount as a salary for services rendered without giving rise to a recapture of SBI credits.

56 Where a business loss was carried back to a year in which a credit had been claimed, the maximum tax recoverable should be the net amount paid after credit. This would have the effect of recapturing all or part of the credit and the investment previously utilized would be eligible for carry-forward.

Transition Rules

57 The SBI credit should not be available to the extent that a corporation is entitled to the lower rate of tax during the proposed transition period. One method of accomplishing this might be to treat as equivalent to a non-qualified investment an amount equal to double any tax reduction accomplished through use of the lower corporate rate. Thus, only increased owner-operator investment in excess of that amount would be eligible for SBI credits.

58 No investment by the owner-operator prior to the start-up of the new system would qualify for SBI credit. Thus, the cost of investments would exclude investments made prior to the commencement of the system.

PART II

WORKING EXAMPLES, COMPARISONS AND SUPPORTING MATERIAL

NOTES TO APPENDICES

Appendix A sets out a number of arithmetical examples designed to illustrate the operation of the small business incentive.

Appendix B compares the impact of the present Canadian tax system with that of the United States and that proposed under the federal white paper.

Appendix C compares the relative weight of federal estate taxation in Canada with that in the United States.

Appendix D illustrates the tax rate effects of size limits for a corporate level small business incentive.

APPENDIX A

EXAMPLES OF ONTARIO'S PROPOSED SMALL BUSINESS INCENTIVE

Example

EXAMPLES OF ONTARIO'S PROPOSED SMALL BUSINESS INCENTIVE

Example 1 SBI Credit Arising as a Result of Increased Investment in a Proprietorship, Partnership or a Corporation

It is expected that the initial test of increased qualified investment can be made by the owner-operator merely by comparing the value of his investment in the business at the beginning and end of the year. Where an individual owner-operator formed a proprietorship or a corporation (or joined a partnership) to carry on a business during a year and invested $2,500 in the business he would make the following calculations.

Investment at end of year			$2,500
Investment at beginning of year			0
Increase for the year			$2,500
Limits on SBI credit			
50% of increased investment ($2,500)	=	$1,250	
or			
50% of tax otherwise payable (say $4,000)	=	$2,000	
Lesser, which is within annual limit of $10,000	=		$1,250

On filing his tax return he would take a tax credit of $1,250 against his tax otherwise payable of $4,000, thus reducing his current tax payment to $2,750 and providing a further $1,250 for use in the business.

Example 2   Accounting for SBI Credits Claimed

For capital gains tax purposes, it would be necessary, in the normal course, that a taxpayer maintain a record of the "adjusted cost basis" of his investment for purposes of computing a subsequent capital gain or loss. The $2,500 invested in the common shares of a company would initially give a cost basis of $2,500 and a sale of those shares for some other amount would give rise to a capital gain or loss.

It is proposed that the election to claim the small business incentive give rise to an adjustment to the cost basis of the shares to the extent that the increased investment has given rise to an SBI credit. Since in the first example, the full $2,500 of increased investment has given rise to SBI credit, the taxpayer would reduce the cost basis of his investment by $2,500 to zero.

Adjusted cost basis of common shares –	
Initial cost	$2,500
Reduction due to claiming SBI credit	2,500
Adjusted cost basis	$ 0

Example 3 Accounting for SBI Credits on Realization of Investment

The taxpayer would keep track of any SBI credit claimed in much the same way as he must do when accounting for depreciable property and recaptured capital cost allowances. In the same way as recaptured capital cost allowances are taxed as ordinary income and any proceeds in excess of original cost are treated as a capital gain, any realization in excess of the adjusted cost basis of the investment would be considered a recovery of any SBI credit claimed and any additional gain would be taxed as a capital gain. This is illustrated in the following three cases in which the owner-operator has previously claimed SBI credits of $10,000 in respect of $20,000 of investment.

	Owner-Operator		
	A	B	C
Sale proceeds – say	$10,000	$20,000	$30,000
Adjusted cost basis	0	0	0
Gain	$10,000	$20,000	$30,000
Gain taxed as –			
Recapture of SBI investment at 50% rate	$10,000	$20,000	$20,000
Capital gain at 25% rate			10,000
	$10,000	$20,000	$30,000
Tax payable –			
Recaptured SBI credit	$ 5,000	$10,000	$10,000
Capital gains tax			2,500
	$ 5,000	$10,000	$12,500

Example 4 Effect on Lifetime Limits of Recovered SBI Credits

In determining the lifetime amount of SBI credits (for the $100,000 lifetime limit), any amounts claimed would be reduced by amounts recaptured. Thus, amounts recaptured would effectively restore a portion of the right to additional credits during lifetime. To the extent the taxpayer suffered a loss (measured by reference to the adjusted cost basis) on an investment on which SBI credits had been claimed, any net capital loss would be deductible against capital gains and there would be no recapture of SBI credits. However, credits claimed would continue to be included in determining the lifetime maximum. This is illustrated below.

	Owner-Operator	
	A	B
Original investment	$30,000	$30,000
SBI credits of $5,000 previously claimed and cost basis adjusted by	10,000	10,000
Adjusted cost basis	20,000	20,000
Sale proceeds – say	15,000	30,000
Gain or (loss)	$(5,000)	$10,000
Recaptured SBI investment – taxable at 50%	$ 0	$10,000
Recaptured SBI credits	$ 0	$ 5,000
Computation of lifetime limits –		
SBI credits previously claimed	$ 5,000	$ 5,000
Less recaptured during the year		5,000
Portion of lifetime limit utilized	$ 5,000	$ 0

Example 5 *Carry-Forward of Portion of Increased Investment not Utilized for SBI Credits*

In some cases the owner-operator would not be able to utilize his full increased investment for SBI credit in the year of investment and the unused investment could be carried forward (and back one year) to provide SBI credits in another year. This is illustrated below.

	Owner-Operator			
	A	B	C	D
Increased investment in capital stock of corporation – say	$ 2,000	$10,000	$20,000	$30,000
Tax otherwise payable – say	1,000	12,000	18,000	40,000
Limits on SBI credit –				
i) Annual maximum	10,000	10,000	10,000	10,000
ii) 50% of increased investment....	1,000	5,000	10,000	15,000
iii) 50% of tax otherwise payable ..	500	6,000	9,000	20,000
SBI credit........................	500	5,000	9,000	10,000
Increased investment utilized for SBI credit	1,000	10,000	18,000	20,000
Increased investment eligible for carry-forward	1,000	0	2,000	10,000

Example 6 *Accounting for Investment where Part of Increased Investment not Utilized for SBI Credit*

The effect of utilizing only a portion of the increased investment for SBI credit on the taxpayer's accounting for his investment in the company is illustrated below, using the facts as in Example 5.

	Owner-Operator			
	A	B	C	D
Adjusted cost basis of investment in company at the beginning of the year – say	$5,000	$10,000	$50,000	$100,000
Increased investment during the year	2,000	10,000	20,000	30,000
	7,000	20,000	70,000	130,000
Reduction due to claiming SBI credit . . .	1,000	10,000	18,000	20,000
Adjusted cost basis	$6,000	$10,000	$52,000	$110,000

Example 7 Utilizing the Investment Carry-Forward

Where the owner-operator had unused increased investment which was carried forward from a prior year, he would treat the carry-forward as an additional investment of the current year for the purpose of computing his SBI credits. The procedure which might be followed is illustrated below, carrying on with the facts of the two previous examples.

	Owner-Operator			
	A	B	C	D
Investment at beginning of year	$ 6,000	$10,000	$52,000	$110,000
Increase or (decrease) in investment during the year	1,000	0	(2,000)	10,000
Investment before SBI credit	$ 7,000	$10,000	$50,000	$120,000
Determination of SBI credit –				
Increased investment of the year	$ 1,000	$ 0	$(2,000)	$ 10,000
Add carry-forward	1,000	0	2,000	10,000
	$ 2,000	$ 0	$ 0	$ 20,000
Limits –				
i) Annual maximum	$10,000	$10,000	$10,000	$10,000
ii) 50% of increased investment	1,000	0	0	10,000
iii) 50% of tax otherwise payable	500	6,000	9,000	20,000
SBI credit	500	0	0	10,000
Increased investment utilized for SBI credit	1,000	0	0	20,000
Adjusted cost basis of investment	6,000	10,000	50,000	100,000
Increased investment eligible for carry-forward	1,000	0	0	0

The SBI credit would only be available if the taxpayer qualified as an owner-operator during the year. Thus, any carry-forward would be ineffective, if in the subsequent year the taxpayer had ceased to qualify as an owner-operator, but the amount would continue to be eligible for carry-forward should he subsequently reacquire owner-operator status. Ceasing to qualify as an owner-operator would not give rise to a recapture of SBI credits if there had been no taxable realization.

Example 8 Change of Form of Investment in the Business

It is proposed that the investment by the owner-operator be eligible for SBI credit whether invested by way of capital or debt. Similar accounting would be followed for each and a transfer from one to the other should have no tax effect.

Investment by an owner-operator in his company –		
Capital stock		$ 2,000
Advances		1,000
Increased investment		$3,000
Tax otherwise payable – say		$1,200
Limits on SBI credit		
i) Annual maximum	$10,000	
ii) 50% of increased investment	1,500	
iii) 50% of tax otherwise payable	600	
SBI credit (reducing tax to $600)		600
Increased investment utilized for SBI credit		1,200
Increased investment eligible for carry-forward		1,800
Cost basis of investment –		
Capital stock		$ 2,000
Less reduction due to claiming SBI credit – 2/3 x $1,200 =		800
Adjusted cost basis		$ 1,200
Advances		$ 1,000
Less reduction due to claiming SBI credit 1/3 x $1,200 =		400
Adjusted cost basis		$ 600

If in the following year the advances were converted to further common stock his investment account would be treated as follows.

Investment at beginning of year	$ 1,800
Advances converted to common stock, treated as a rollover and cost basis of advance would become cost basis of capital stock	0
Adjusted cost basis before SBI credit for current year	$ 1,800

The conversion of the advance to common stock would have no effect on the cost basis of his stock and would not give rise to any increase or decrease in investment for SBI credit. However, in this example, the owner-operator does have a carry-forward of unused increased investment of $ 1,800 and thus may be eligible for SBI credit in the current year.

Example 9 Withdrawal of a Portion of Investment

If in the following year, the owner-operator in Example 8 withdrew half of his advances and converted the other half to common stock, then the net reduction in investment could give rise to recapture of part of the SBI credit. This would be computed as follows.

	Common stock	Advances
Adjusted cost basis beginning of year	$ 1,200	$ 600
Withdraw half of advances (i.e. $500)		(500)
Convert half of advances ($500) to common stock – rollover – no tax effect	300	(300)
Adjusted cost basis before SBI credit	$ 1,500	$ (200)
Increased investment carry-forward from prior years		$1,800
Advances not reinvested – tax value		(300)
– recapture of SBI credit		(200)
Net increased investment available for further carry-forward		$1,300

If there had been no carry-forward of unused credits the $200 gain on the receipt of the advance,

i.e. –	cash received	$500
	less adjusted cost basis	300
	gain	$200

would have given rise to a recapture of the SBI credit on the $200 – a tax of $100 (50% x $200).

Example 10 Assignment of SBI Credits to Specific Investments

The claiming of SBI credit would be optional to the taxpayer and he could assign all or any part of it to his investment in the company as he saw fit. Thus,if he wished to increase his capital stock investment and in addition to advance temporary funds to the company by way of loan, he might logically decide to assign the SBI credit firstly to his capital stock investment, thereby reducing the element of recapture when he subsequently withdrew his temporary loans.

Investment by owner-operator in his company –			
Common stock		$ 2,000	
Advances			$ 1,000
SBI credit available – say	$ 1,200		
Increased investment utilized for SBI credit	2,400	2,000	400
Adjusted cost basis of investment		$ 0	$ 600
Increased investment available for carry-forward			$ 600

A withdrawal of these advances would have no effect on the common stock position and would be treated in the following manner.

Proceeds from advances	$ 1,000
Less adjusted cost basis	600
Gain	$ 400
Tax – at 50%	$ 200

The increased investment carry-forward would be adjusted as follows.

Increased investment carried forward	$ 600
Less cost basis of advances withdrawn	600
Balance available	$ 0

The owner-operator is thus in the same net position as if he had invested the $2,000 in common stock only, and claimed $1,000 SBI credit in respect thereof.

With this suggested flexibility to the owner-operator in dealing with his investment it would be necessary to provide some rules to prevent SBI credit being claimed in respect of investment made late in the year and withdrawn early in the next. It would seem that rules similar to those now used in dealing with corporate loans to shareholders (i.e. a one-year minimum investment test together with restrictions against a series of investments and withdrawals) could be used to preclude this type of investment from qualifying. The restrictions relating to qualified investments would constitute additional protection against such a practice.

Example 11 Maximizing SBI Credits

The owner-operator would have considerable flexibility in dealing with the SBI credit. For example, if an owner-operator owned all of the shares of a corporation with earnings of $35,000 (before salary to him and corporate tax) he might deal with the company in the following way.

Profit of corporation before owner-operator salary and corporate tax	$35,000
Salary to owner-operator to provide him with after-tax funds of $12,000	15,000
Profit of corporation before tax	20,000
Corporate tax	10,000
Retained earnings	$10,000

This example assumes proportional assignment of SBI credit between investments in the business. Example 10 deals with the situation where the credit is assigned disproportionately.

In this case the corporation has retained earnings of $10,000 for expansion and the owner-operator has a maximum potential SBI credit of approximately $1,500 (50 per cent of his tax otherwise payable of $3,000) if he should invest further funds in the corporation. The retention of earnings by the corporation would not in itself give rise to any SBI credit to the owner-operator.

As an alternative to the above the owner-operator could draw the full $35,000 as salary and in this way increase his SBI credit and his funds available.

Profit of corporation before owner-operator salary and corporate tax	$35,000
Salary to owner-operator	35,000
Profit of corporation	$ 0

His personal tax on a salary of $35,000 would be of the order of $12,000. Thus by reinvesting at least $12,000 in the business the owner-operator can reduce his current tax to $6,000 after SBI credit. In this way he could increase the funds at work in the corporation from $10,000 (above) to $17,000 as follows.

Owner-operator salary from company		$35,000
Deduct:		
Tax to be paid after SBI credit	$ 6,000	
Personal requirements other than tax (as above)	12,000	18,000
Funds for investment in company		$17,000

The SBI credit limits would be –	
i) Annual maximum	$10,000
ii) 50% of increased investment	8,500
iii) 50% of tax otherwise payable	6,000
SBI credit	6,000
Increased investment eligible for carry-forward	5,000

The cost basis of his investment in the company would be adjusted	
by the amount of additional investment of	$17,000
less the portion utilized for SBI credit of	12,000
a net amount of	$ 5,000

Example 12 *Comparison of SBI Credit System with Present Lower Corporate Rate for Company Earning $35,000 of Taxable Income*

In the situation of a growth company earning $35,000 before tax but after owner-operator salary, the SBI credit could provide approximately the same funds for use in the business as the present lower rate of corporate tax. This is illustrated below.

	Present System	Proposed System with SBI Credit
Corporate profit before owner-operator salary	$50,000	$50,000
Salary to owner-operator (personal tax thereon $3,000)	15,000	15,000
Profit after salary	$35,000	$35,000
Additional salary to owner-operator		35,000
Corporate tax	8,000	
Corporate earnings after tax	$27,000	$ 0
Additional owner-operator investment		28,000
Increased funds invested in corporation	$27,000	$28,000

The owner-operator's tax on a total salary of	$50,000	
would be approximately		$20,000
Since he has increased his investment by	$28,000	
he would be entitled to the maximum SBI credit of	$10,000	
and thus his net tax would be		$10,000
Since his tax on a $15,000 salary would in any event have been		3,000
the additional tax to be paid would be		7,000
Thus the additional salary of		35,000
has provided him with after-tax funds to increase his investment by		$28,000

Example 13 *Comparison of SBI Credit System with Present Lower Corporate Rate for Companies Earning Less Than $35,000 of Taxable Income*

The SBI credit would also be of equal or greater advantage in providing funds when compared to the lower corporate rate in lower-income situations as illustrated in the following examples.

	A	B	C
Present system –			
Profit before owner's salary	$10,000	$20,000	$35,000
Salary	7,500	15,000	15,000
Corporate profit	$ 2,500	$ 5,000	$20,000
Corporate tax – approximately	600	1,200	4,600
Earnings retained for use in the business	$ 1,900	$ 3,800	$15,400
SBI credit system –			
Profit before owner's salary	$10,000	$20,000	$35,000
Salary	10,000	20,000	35,000
Corporate profit	$ 0	$ 0	$ 0
Personal tax on salary – approximately	$ 1,600	$ 5,100	$12,300
Less SBI credit	800	2,500	6,100
Net tax	$ 800	$ 2,600	$ 6,200
Funds available after tax	$ 9,200	$17,400	$28,800
Funds required for personal needs (other than tax – see below)	6,600	12,100	12,100
Funds reinvested for use in the business	$ 2,600	$ 5,300	$16,700
Funds available for personal needs –			
Salary (as above)	$ 7,500	$15,000	$15,000
Less personal tax thereon – approximately	900	2,900	2,900
Net after tax – same under each system	$ 6,600	$12,100	$12,100

Example 14 Comparison of SBI Credit System with Present Lower Corporate Rate Where After-Tax Earnings of Corporation are Withdrawn

One criticism of the present lower rate of corporate tax is that it is available whether or not the funds are reinvested in the business. It is possible to withdraw the corporate profits in a number of ways without disturbing the entitlement to the lower rate. Thus an owner-operator having a company earning $50,000 could elect to draw those earnings in the following way.

		Tax thereon
$15,000	by way of salary	$ 2,900
13,500	by way of dividend	3,000[1]
13,400	by corporate election to pay a 15% tax	2,000[2]
$41,900		$ 7,900
8,100	tax paid by corporation on $35,000	8,100
$50,000		$16,000

Notes: 1 Tax on $15,000 of salary plus $13,500 of dividends from taxable Canadian corporations, less personal exemptions and deductions (married taxpayer with two children) is approximately before dividend tax credit of 20% x $13,500 =

	$ 8,600
	2,700
	$ 5,900
Less tax on salary	2,900
Tax on dividend	$ 3,000

2 This election is generally available to Canadian corporations and permits distribution to shareholders of amounts equal to dividends paid at tax cost of 15 per cent.

Thus he could provide himself with net funds of $34,000 out of the corporate earnings of $50,000.

By restricting the SBI credit by reference to funds invested in the business, it is automatically denied if funds are not invested or is recaptured if they are subsequently withdrawn. Thus in those cases where funds are not to be invested, the owner-operator would be free to draw the total corporate earnings for consumption and his tax would be of the same magnitude as any other Canadian individual with earned income of $50,000 – approximately $20,000.

Example 12 illustrated the means by which the owner-operator could provide for his personal needs through salary and have approximately $28,000 for investment in his business. If there was no real intention of increasing the investment, on withdrawal of the funds the owner-operator would end up in the same position as if he had initially drawn and retained the total corporate profits as salary.

		Tax thereon
$50,000	salary initially drawn	$20,000
(28,000)	reinvested	(10,000)
$22,000		$10,000
28,000	withdrawal of investment	10,000
$50,000		$20,000

Example 15 Transfers from One Qualified Investment to Another

A change in investment between two qualifying businesses should be acceptable within the general limits and could work as follows.

	Owner-operator having two qualified businesses operated by two different corporations	
	Co. X	Co. Y
Adjusted cost basis of investment	$ 5,000	$20,000
Withdrawal of investment from X - say	20,000	
Gain – all being SBI credits claimed in prior years	$(15,000)	
Additional investment in Y		25,000
	$(15,000)	$45,000

The owner-operator would have the right to offset his otherwise taxable gain on his investment in X against his new investment in Y without any limits as to amount and without affecting his general right to SBI credit in that year. By this election he would defer tax on the $15,000 gain. His cost basis in Y would be reduced from $45,000 to $30,000 and his increased investment in Y from $25,000 to $10,000 for purposes of determining his SBI credit for the year.

Example 16 Investment in Non-qualified Assets

It is intended that the SBI credit act as an incentive to increased investment in Canadian business. Thus, investment in non-qualified assets should disqualify the increased investment or be treated as a realization by the shareholder on his investment to the extent of his accumulated SBI credits. This is illustrated below.

Year 1

Owner-operator invests in new Company A	$20,000
Maximum SBI credit is claimed and cost basis of stock written down	20,000
Adjusted cost basis	$ 0

Year 2

Company invests in non-qualifying assets (i.e. shares of X Public Company)	$10,000
For SBI credit purposes, this would be treated as a realization by the owner-operator on his investment of	$10,000

This would give rise to a gain in his hands taxable at a 50 per cent rate as a recapture of the SBI investment and credit – a tax of $5,000. The cost basis of his investment would be restored to $10,000 for further capital gains tax purposes. The non-qualified investment would be treated as a realization only to the extent of the amount invested and would not totally disqualify the owner-operator from SBI credits.

It might be possible to permit qualified investment through a chain of corporations but detailed rules would need to be prescribed. It would seem preferable, at least initially, to restrict the SBI credit to direct investment of the owner-operator. Investment by a parent company in a wholly-owned subsidiary should not be treated as a realization provided the owner-operator of the parent also qualified as an owner-operator of the subsidiary. In such cases the two companies should be considered on a consolidated basis.

Example 17 Acquisition of an Existing Business having Non-qualified Investment

It should not be necessary that the funds be invested directly in the business by the owner-operator but an investment made to acquire an existing business should be eligible subject to the general rules and restrictions. Again, the cost basis of the owner-operator's investment should be the main determinant and not the amounts of capital reflected on the corporate balance sheet. Should the acquired corporation have non-qualified investment, the amount of qualified increased investment of the owner-operator should be reduced by the value of that non-qualified investment at the time he acquires the company.

Corporate balance sheet

Investment in shares of X Public Co. (market value $30,000) – cost	$ 20,000
Other assets	100,000
	$120,000
Liabilities	$ 75,000
Capital and surplus	45,000
	$120,000

If an individual acquired two-thirds of the shares of this company for $50,000, that amount would be the cost basis of his investment. In determining the amount of his increased investment for the year, the $50,000 should be reduced by his proportionate interest in the $30,000 value of non-qualified investments (i.e. $20,000) leaving only $30,000 as eligible in determining the amount of any SBI credit.

Example 18 Accumulated Non-qualified Investment

If a corporation had accumulated an amount of non-qualified investment, the adjusted cost basis of the owner-operator in the corporation would need to exceed the value of the non-qualified investment before he would be entitled to claim any SBI credit. This is illustrated as follows.

Adjusted cost basis of investment in company (no SBI credits previously claimed)	$50,000
Increase in investment during the year	25,000
	$75,000
Value of non-qualified investments on hand in the company	60,000
Amount of increased investment to be used in determining SBI credit	$15,000

Example 19 Corporations Eligible for Lower Rate of Tax during the Transition Period

It is proposed that the SBI credit should not be available to the extent that a corporation is entitled to the lower rate of tax. One method of accomplishing this might be to treat as equivalent to a non-qualified investment an amount equal to double any corporate tax reduction accomplished through the use of the lower corporate rate. Thus, only increased owner-operator investment in excess of that amount would be eligible for SBI credits.

Increased investment made in the year	$30,000
Difference between amount of corporate tax paid during transition period at the lower rate and tax which would have been payable at the higher rate, say $12,500 x 2 =	25,000
Increased investment eligible for SBI credit	$ 5,000

Example 20 Unincorporated Businesses

The above examples have been drawn to illustrate the position with regard to corporate investment. It is expected that much the same procedures could be adopted for owner-operators of unincorporated businesses. However, some more detailed rules would need to be developed since it is unusual for proprietors and partners to buy, sell, or otherwise deal with business interests. Rather, they tend to deal with specific assets. In general, it is believed that the owner-operator of a proprietorship or partnership should be permitted the SBI credit in the same way as the owner-operator choosing the corporate form to carry on his business.

	Owner-operator		
	A	B	C
Profit of business before proprietor's drawings	$10,000	$20,000	$30,000
Drawings for tax and other personal needs –			
Tax – approximately	$ 1,500	$ 5,000	$ 9,000
Other – say	6,000	10,000	6,000
	$ 7,500	$15,000	$15,000
Increased investment	$ 2,500	$ 5,000	$15,000
SBI credit limits –			
i) Annual maximum	$10,000	$10,000	$10,000
ii) 50% of increased investment	1,250	2,500	7,500
iii) 50% of tax otherwise payable	750	2,500	4,500
SBI credit which would provide additional capital for business financing	750	2,500	4,500
The proprietor's capital in the business would have increased by	2,500	5,000	15,000
but would have an increased cost basis of only	1,000	0	6,000

Example 21 Rollover and Capital Gains Treatment on Recovered SBI Credits

The following example illustrates the position of an owner-operator who has an adjusted cost basis for his investment in the capital stock of his corporation of $20,000. He has previously claimed SBI credits of $30,000 as a result of $60,000 of increased qualified investment.

Proceeds of sale of shares	$100,000
Adjusted cost basis	20,000
Gain	$ 80,000

Allocation of gain –	Amount	Tax
Recapture of SBI credits	$ 60,000	$ 30,000
Capital gain	20,000	5,000
Total	$ 80,000	$ 35,000

It was previously indicated that the owner-operator could defer the recapture of his SBI credits should he reinvest the proceeds of sale, otherwise representing a recapture of SBI investment (i.e. $60,000), in another qualified business. Unless a general rollover was available for capital gains he would not be required to reinvest the total proceeds of sale but only an amount equal to the recaptured investment.

As a further incentive to retention of investment, it could be provided that to the extent a gain represented a recapture of SBI investment the amount of that investment could be eligible for rollover into any investment after some suitable length of time, say five years after it was utilized for SBI credit. The cost basis of the new investment would be reduced by the amount of the deferred recapture and thus would be exposed to capital gains tax on subsequent realization. If such treatment were to be permitted the immediate tax might be computed as follows.

	Amount	Immediate Tax
Allocation of proceeds		
Recovery of adjusted cost	$20,000	$ 0
Recapture of SBI credits claimed in previous 5 years – say	20,000	10,000
Recapture of SBI credits claimed beyond 5 years – say	40,000	0[1]
Capital gain	20,000	5,000
	$100,000	$15,000

If the amount reinvested was	$75,000
Adjusted cost basis would be	$35,000
and a subsequent sale for	80,000
would give rise to a gain of	$45,000
and tax of	$11,250

[1] Assuming at least $40,000 reinvested.

APPENDIX B

SMALL BUSINESS UNDER THE PRESENT CANADIAN, THE UNITED STATES AND THE FEDERAL WHITE PAPER TAX SYSTEMS

The following examples illustrate the relative position under the three tax systems of an individual forming a business and dealing with it in a number of possible ways. As in all such comparisons it is necessary to make a number of assumptions. While those used are felt to be reasonable, alternative assumptions are clearly available. The general assumptions used in all examples are summarized at the end of this appendix. Additional assumptions used in specific examples are noted at the end of those examples. All amounts have been rounded to show approximate sums since the intention of the examples is to illustrate the relative impact under the three systems.

Example 1

The following table contrasts the situation at various profit levels for owner-operators carrying on business in corporate form under the present system and under the federal white paper system. It clearly illustrates the annual loss of funds available as a result of the white paper tax proposals.

	Company	Tax Under Present System(1)	Tax Under White Paper Proposals(2)	Annual Loss of Funds Available
Profit before owner's salary	$10,000			
Salary	7,500	$ 900		
Profit	$ 2,500	600		
Tax		$ 1,500	$ 1,600	$ 100
Profit before owner's salary	$20,000			
Salary	15,000	$ 2,900		
Profit	$ 5,000	1,200		
Tax		$ 4,100	5,100	1,000
Profit before owner's salary	$35,000			
Salary	15,000	$ 2,900		
Profit	$20,000	4,600		
Tax		$ 7,500	12,300	4,800
Profit before owner's salary	$50,000			
Salary	15,000	$ 2,900		
Profit	$35,000	8,100		
Tax		$11,000	20,000	9,000
Profit before owner's salary	$70,000			
Salary	35,000	$11,500		
Profit	$35,000	8,100		
Tax		$19,600	29,500	9,900

Notes: (1) No provision has been made in the above calculations of tax under the present system for tax payable on the distribution to the shareholder of earnings retained in the corporation.

(2) It is assumed that any corporate tax paid would be fully creditable to the shareholder under the white paper proposals.

Example 2

The absence of a capital gains tax under the present system means that a sale of the shares of a corporation can generally be made by one Canadian individual to another, without concern that his capital will be depleted through the sale. Under the federal white paper proposals the same would be true only in those instances where the sale price did not exceed book value and where the corporate retained earnings were fully covered by creditable tax. This is illustrated below.

		Federal White Paper System	
	Present System	If Sale Price Equal to Fully Taxed Retained Earnings	If Sale Price Solely for Goodwill
Gain on sale of shares of a private company	$200,000	$200,000	$200,000
Portion of gain to be taxed	0	0	100%
Approximate tax payable	0	0	$100,000
Capital available for new investment	$200,000	$200,000	$100,000

Example 3

In order to avoid the double impact on death of a tax on goodwill and other capital gains together with estate taxes, the federal government proposed in the white paper that there be no deemed realization of capital gains on death. Rather, the beneficiary would assume the cost basis of the investment of the deceased to which he would add the applicable portion of any death duties payable. On an inter-generation transfer this would work somewhat as follows.

Value of assets in estate for estate tax purposes	$1,000,000
Approximate estate taxes payable	430,000
Net estate after taxes	$570,000

If the estate of $1,000,000 consisted of $450,000 of cash or assets readily convertible into cash, and $550,000 of investment in the shares of a private company, the cash could be used to pay the duties and the beneficiary would receive $20,000 in cash and the shares of the company valued at $550,000.

If the deceased's cost basis of the shares were $250,000, the portion of the duties pertaining to the unrealized gain would be approximately $129,000 ($\frac{\$300,000}{\$1,000,000}$ x $430,000) and thus the cost basis of the beneficiary in the shares of the company would be increased to $379,000. Should he subsequently sell the shares of the company at the price at which they had been valued for estate tax purposes (i.e. $550,000) he would realize a gain of $171,000 on which his tax payable would be of the order of $85,000. This would leave him with cash of approximately $485,000 from the estate.

Example 4

If the estate were not as liquid as that described in the previous example the estate might find it necessary to sell the shares of the company to pay death duties. Alternatively, it might be necessary to sell the shares because of an existing buy-sell agreement or some other condition might make it necessary or desirable that the shares be sold. In such situations the non-recognition of unrealized gains at death would be of no advantage to the estate. The following table contrasts the present Canadian tax system, that of the United States and that under the federal white paper where the estate finds it necessary or desirable to sell an asset of the deceased which has appreciated considerably in value. As in the above example, the taxes payable are those which would apply on an inter-generation transfer.

Assets of estate:

Shares of private company (adjusted cost basis $300,000)	$ 800,000
Other assets	200,000
Total	$1,000,000

	Present Canadian Position	Present United States Position	White Paper Position
Approximate estate tax payable	$314,000	$304,000	$429,000
Approximate tax on capital gain	(1)	(2)	142,000
Total tax	$314,000	$304,000	$571,000
Assets passing to beneficiaries	$686,000	$696,000	$429,000

Notes: (1) No tax on capital gains.

(2) Cost basis is adjusted to value for estate tax purposes – hence no gain to be taxed.

Example 5

The following example illustrates the position of an individual who forms a corporation which carries on a business earning $30,000 per year before tax and before salary to the owner-operator. The owner-operator draws a $15,000 salary (which is his sole source of income) leaving $15,000 of before-tax profits in the company. After ten years, he sell his shares for an amount equal to book value.

	Present Canadian Position	Present United States Position		Federal White Paper Position
		No state tax	With state tax	
Profit of corporation before tax and salary	$ 30,000	$ 30,000	$ 30,000	$30,000
Salary to owner-operator	15,000	15,000	15,000	15,000
Profit before tax	$ 15,000	$ 15,000	$ 15,000	$15,000
Approximate tax payable –				
– by individual	$ 2,900	$ 2,300	$ 2,600	$ 9,800
– by corporation	3,500	3,300	4,200	
Retained earnings of corporation	11,500	11,700	10,800	8,100(1)
If earnings were permitted to accumulate in the corporation for ten years, they would total (3)	115,000	117,000	108,000	81,000
If the shares should then be sold at a price equal to retained earnings, tax on the gain would amount to	Nil	25,000(2)	26,000(2)	Nil
This would provide the owner with a net after-tax receipt of	115,000	92,000(2)	82,000(2)	81,000

Notes: (1) On the assumption that the increased total tax on integrated earnings will be paid through reduced retention of corporate earnings.

(2) The United States tax on the capital gain is computed ignoring the possibility of a tax-free rollover which, in practice, is frequently available where a substantial gain is involved. Tax has been computed by including 50% of the gain in income taxable under the personal rate structure. No reduction in tax would be accomplished by using the alternative tax on net long-term capital gains (which is being increased over a period of years from 25% to 35% of any gains in excess of $50,000 in any year). The special 10% tax on tax preference items has been included. For 1970 and subsequent years net long-term gains are eligible for income averaging and in all likelihood would result in some reduction in the amount of tax shown to be payable on the gain.

(3) This ignores any growth in earnings which would arise as a result of the retention of corporate earnings for use in the business.

Example 6

It is difficult to anticipate the effect of the federal white paper proposals on the sale price of the shares of a company such as that described in Example 5, where the annual after-tax earnings and retained earnings are reduced, but the retained earnings can be considered to be totally tax-paid. As noted above, the increased current tax under the white paper proposals reduces the annual after-tax profits from $11,500 to $8,100. If, despite this reduction in retained earnings, the shares of the company could still be sold for the same amount under either situation the relative tax positions would be as follows.

	Present Canadian Position	Present United States Position		Federal White Paper Proposal
		No state tax	With state tax	
If the shares should be sold for $200,000, tax on the gain would amount to	Nil	$ 51,000(2)	$ 57,000(2)	$ 61,000(1)
This would provide the owner with a net after-tax receipt of	$200,000	149,000	143,000	139,000
If the company should go public and the owner then sells his shares for $200,000, tax on the gain would amount to ..	Nil	51,000(2)	57,000(2)	30,000(1)
This would provide the owner with a net after-tax receipt of	200,000	149,000	143,000	170,000(3)

Notes: (1) Tax would apply on the goodwill portion of the gain only; at regular rates on the gain if sold as a CHC or at regular rates on one-half the gain if sold as a WHC.

(2) See, Example 5, note (2)

(3) This calculation indicates the net after-tax receipt to the shareholder on his company going public. As a result of this action the shareholder would be subject to tax on unrealized gains on those shares every five years under the revaluation proposal.The United States has no similar provision and, as illustrated previously, a tax-free step-up of cost basis is provided on the death of the shareholder.

Example 7

The following example is similar to Example 5 but deals with a higher income situation. It illustrates the position of an individual who forms a corporation which carries on a business earning $70,000 per year before tax and before salary to the owner-operator. The owner-operator draws a $35,000 salary (which is his sole source of income) leaving $35,000 of before-tax profits in the company.

	Present Canadian Position	Present United States Position		Federal White Paper Proposal
		No state tax	With state tax	
Profit of corporation before tax and salary	$ 70,000	$ 70,000	$ 70,000	$ 70,000
Salary to owner-operator	35,000	35,000	35,000	35,000
Profit before tax	$ 35,000	$ 35,000	$ 35,000	$ 35,000
Approximate tax payable –				
– by individual	$ 11,500	$ 7,500	$ 9,100	$ 29,500
– by corporation	8,100	10,300	12,200	
Retained earnings of corporation	26,900	24,700	22,800	17,000(1)
If earnings were permitted to accumulate in the corporation for ten years, they would total (3)	269,000	247,000	228,000	170,000
If the shares should then be sold at a price equal to retained earnings, tax on the gain would amount to ...	Nil	72,000(2)	72,000(2)	Nil
This would provide the owner with a net after-tax receipt of	269,000	175,000	156,000	170,000
If the shares should be sold for $400,000, tax on the gain would amount to	Nil	127,000(2)	137,000(2)	118,000
This would provide the owner with a net after-tax receipt of	400,000	273,000	263,000	282,000

	Present Canadian Position	Present United States Position		Federal White Paper Proposal
		No state tax	With state tax	
If the company should go public and the owner then sells his shares for $400,000, tax on the gain would amount to . . .	Nil	127,000(2)	137,000(2)	59,000
This would provide the owner with a net after-tax receipt of	400,000	273,000	263,000	341,000(4)

Notes: (1) See Example 5, note 1

(2) See Example 5, note 2

(3) See Example 5, note 3

(4) See Example 6, note 3

General Assumptions Used in the Above Examples

1. The individual is a married taxpayer with two dependent children under the age of 16 years.

2. Taxes were computed giving effect to the following:

   a) Present Canadian tax –

      - deductions in respect of pension contributions, retirement savings plan premiums, medical expenses, charitable donations, union and professional dues, alimony and other deductions were calculated by reference to average deductions claimed in respect of these items by all taxpayers in the applicable income ranges for the year 1966 as shown in published taxation statistics;

      - Canada Pension Plan premiums were included as were provincial taxes applicable to residents of Ontario;

      - the family allowance payments for the two dependants have been deducted from the final tax liability. It has been assumed that the monthly family allowance payment is $14; and

      - an effective corporate tax rate of 23 per cent on the first $35,000 of taxable income and 52 per cent on any balance has been used.

b) Present United States tax –

- taxes were computed and shown for two situations, the first being applicable to those states which do not impose an income tax and the second for New York State, where state income taxes are generally amongst the highest imposed in the United States;

- United States taxes were computed by reference to the tax reform measures approved by the President in December, 1969 applicable to 1971. No provision was made for the increase in personal exemptions proposed for 1972 and subsequent years;

- social security premiums as revised for 1971 have been included;

- it was assumed that itemized deductions would be claimed. The amount deducted for each income class was computed by reference to the average itemized deductions claimed by all taxpayers in each class for the year 1966 These were adjusted to reflect personal exemptions applicable to the example and state income taxes as applicable. Tax payable was computed using rates applicable to those filing joint returns. (In 1966 over 39 million taxpayers filed joint returns while only 2.8 million married taxpayers filed separate returns); and

- a corporate tax rate of 22 per cent on the first $25,000 of taxable income and 48 per cent on any excess has been used in the first situation and effective rates of 28 per cent and 52 per cent in the second.

c) Federal white paper proposed tax –

- in computing tax under the proposed system, the same deductions were made from income as under the present system except:

  – medical expenses were excluded on the grounds that a deduction will not be generally available;

  – a deduction was made in respect of the 3 per cent allowance for expenses incurred in earning income from employment. No provision was made for deductions to be permitted in respect of child care expenses, unemployment insurance premiums or moving expenses. The proposed higher personal exemptions were used;

- transitional rates of tax applicable to taxable incomes in excess of $35,000 were ignored; and

- corporate taxes were assumed to be fully integrated with those of the shareholders, by use of the partnership option or otherwise and all corporate tax was treated as being creditable.

APPENDIX C

ESTATE TAX COMPARISON FOR CANADA AND THE UNITED STATES

Example 1

The following table illustrates the federal estate tax impact for estates of equal size in the United States and in Canada following the 1968 amendments. The calculations assume a married couple with two children over twenty-five years of age. Two situations are shown, the first where one-half of the estate passes to the wife and ultimately to the children while the second half passes immediately to the children. The second case reflects the passage of the whole estate to the wife and then to the two children on her death.

The tax is calculated in both cases on the flow-through of the whole estate to the second generation recognizing that this may be done in separate stages. There may be an estate tax liability in the United States if an estate is left in total to the widow, while there would be none in similar cases for Canadian estates. It has been assumed in such cases where there is a tax liability, that the estate tax is a charge against the widow's portion of the estate. In all other cases any estate tax liability is a charge against the bequest to the children. No attempt has been made to weight the burden of estate taxes, to recognize differences in the timing of payment.

It is assumed that the widow maintains the capital of the estate bequested to her intact but does not add to its value. Only where there is a tax payable by the widow is the capital of the estate left to the widow reduced.

These calculations ignore any estate taxes or succession duties levied by the provinces or the states and accordingly, the estate tax liabilities are shown before federal estate tax credits. Inclusion of provincial or state taxes or duties should not materially alter the general effect of the comparisons.

Estate Tax Payable Where Estate Left One-half to Widow and One-half to Two Children

Value of estate	Canada: Payable at time of death of Husband	Canada: Widow	Canada: Total	United States: Payable at time of death of Husband	United States: Widow	United States: Total
	($ thousand)					
$ 60,000	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
100,000	2	1	3	0	0	0
200,000	11	11	22	5	5	10
300,000	24	23	47	18	18	36
400,000	40	39	79	33	32	65
500,000	59	58	117	48	47	95
1,000,000	179	179	358	127	126	253
1,500,000	304	304	608	212	212	424
2,000,000	429	429	858	304	303	607
5,000,000	1,179	1,179	2,358	969	969	1,938
10,000,000	2,429	2,429	4,858	2,431	2,430	4,861

Estate Tax Payable Where Estate Left Totally to the Widow and on her Death to the Two Children

Value of estate	Canada: Payable at time of death of widow	United States: Payable at time of death of Husband	United States: Widow	United States: Total
	($ thousand)			
$ 60,000	$ 3	$ 0	$ 0	$ 0
100,000	11	0	5	5
200,000	40	5	31	36
300,000	80	18	57	75
400,000	129	33	84	117
500,000	179	48	111	159
1,000,000	429	126	257	383
1,500,000	679	212	415	627
2,000,000	929	303	590	893
5,000,000	2,429	969	1,821	2,790
10,000,000	4,929	2,430	4,210	6,640

It is worth noting that the general effect of these examples is that the United States taxes larger estates, from five to ten million dollars and up, more heavily than Canada, while taxing smaller estates significantly less heavily than Canada.

Example 2

It is difficult to contrast the relative weights of the estate tax as it existed prior to the October, 1968 amendments with that which now exists. Under the amended system, interspousal bequests are totally exempt from tax whereas previously an exemption of $60,000 was provided. The exemption for interspousal transfers is really only a deferment of tax, since the full estate is taxed on passing from the widow to anyone other than another spouse. Dependant exemptions have been varied and now require specific bequests to the dependant in order for the exemption to be available. Gift tax rates have been substantially increased and taxable inter-vivos gifts are now taken into account in determining the estate tax rates to be used. Under the previous system, gift tax rates were much lower than current rates or estate tax rates and inter-vivos gifts generally did not affect the estate tax computation. Finally, the estate tax rate schedule has been substantially altered. Whereas previously, a top rate of 54 per cent applied to taxable values in excess of $2,000,000 (and a 50 per cent rate was reached at a taxable value of $1,550,000), the top rate is now 50 per cent and is reached at a taxable value of only $300,000. At $300,000, the tax is $89,200 and thus for any estate having a taxable value in excess of $300,000 the estate tax may be expressed as being 50 per cent of the estate less $60,800 ($150,000 – $89,200).

The following table contrasts the pre-1968 system with the amended system in the case of an inter-generation transfer to adult children. Under the pre-1968 system, a $40,000 exemption was available and it is assumed that sufficient specific bequests are made to a sufficient number of children to provide a $40,000 exemption under the amended system.

		Estate Taxes	
Aggregate net value of estate	Aggregate taxable value of estate	Pre–1968 Amendments	Post–1968 Situation
$ 50,000	$ Nil	$ Nil	$ Nil
100,000	60,000	10,200	6,600
150,000	110,000	21,400	18,300
200,000	160,000	33,600	32,700
300,000	260,000	60,800	71,200
400,000	360,000	90,700	119,200
500,000	460,000	122,900	169,200
1,000,000	960,000	313,900	419,200
1,500,000	1,460,000	544,300	669,200
2,000,000	1,960,000	795,700	919,200
5,000,000	4,960,000	2,414,900	2,419,200
10,000,000	9,960,000	5,114,900	4,919,200

APPENDIX D

TAX RATE EFFECTS OF SIZE LIMITS TO SMALL BUSINESS INCENTIVES

Senate Committee proposal for a notch provision where taxable income exceeded $100,000	Taxable income	Rate of tax	Tax
On the first	$ 35,000	23%	$ 8,050
On the next	65,000	52	33,800
	$100,000		$41,850
On the next	21,150	100	21,150
	$121,150	52	$63,000
On any additional income		52	

Commons Committee proposal for a disappearing corporate level incentive of approximately $10,000	Taxable income	Rate of tax	Tax
On the first	$ 35,000	(1)	$ 8,200
On the next	70,000	66.3%	46,400
On	$105,000	52	$54,600
On any additional income		52	

Notes: (1) $35,000 x 52% = $18,200
−10,000
$ 8,200

Ontario